Effective Date: April 24, 1995

COORDINATED ISSUE
UTILITIES INDUSTRY
EXCESS DEFERRED TAXES AND SECTION 1341

ISSUE:

Whether the taxpayer, a regulated public utility, may compute its Federal income tax liability under the provisions of section 1341(a) of the Internal Revenue Code (the Code) after making rate reductions ordered by the appropriate regulatory authority related to ‘excess deferred taxes’ created as a result of the lowering of the Federal statutory tax rate by the Tax Reform Act of 1986.

BACKGROUND:

"Excess" deferred taxes for investor owned public utilities were created when corporate tax rates were reduced in 1987. Excess deferred taxes are the portion of previously deferred taxes that, as a result of the reduction in corporate tax rates per the Tax Reform Act of 1986, would not be reversed under typical normalization accounting entries. Because excess deferred taxes are derived from deferred taxes, deferred taxes (and normalization accounting) must be understood before issues related to excess deferred taxes can be properly considered.

Investor owned public utilities, including electric, telephone, gas pipeline, local gas distribution, and water, are regulated by state and Federal regulatory commissions. To obtain reasonable rates for consumers as well as a stable supply of services, regulators allow utilities to both earn a fair rate of return on their investment and recover their operating expenses (i.e. cost of service). To earn a fair rate of return on their investment, utilities are allowed to charge ratepayers an approved rate of return on their rate base. A utility’s rate base is composed of the plant facilities, working capital, and other assets required to provide utility services to customers. A utility’s tariffs are also intended to reimburse the utility dollar for dollar for all operating expenses.

Federal income taxes are a major component of a utility’s operating expenses (cost of service) for ratemaking purposes. One major problem, however, in accounting for Federal income taxes arises from the fact that some transactions (e.g. depreciation) affect the determination of net income for financial (ratemaking) accounting purposes in one reporting period and the computation of taxable income in a different period.

One significant timing difference associated with Federal income taxes centers on depreciation. Utilities ordinarily use straight-line depreciation to determine depreciation expense charged against operating income for book (and ratemaking) purposes. In contrast, accelerated depreciation deductions are permitted by the Internal Revenue Code for determining Federal income taxes. This means that, depending on ratemaking treatment, a utility's income taxes payable (per Federal tax statutes allowing the use of accelerated depreciation to determine taxable income) may differ from the income tax expense that it computes and records for book or ratemaking purposes (using straight-line depreciation). (Although other timing differences are handled with deferred tax accounting techniques, this discussion paper will use the timing difference associated with accelerated depreciation in explaining excess deferred taxes and normalization).

Under normalization, a utility collects more from ratepayers to cover its tax obligation early in the life of a depreciable asset than the utility currently must pay in taxes. The difference is accounted for in a deferred tax account, or reserve. A deferred tax account is a balance sheet account which recognizes the expected future tax consequences of existing differences between book and tax accounts. If tax rates are constant, deferred taxes for this asset are built up in the account and then drawn down to zero over the asset's life as lower tax charges during the asset's early years are followed by higher taxes during its later years. (See the example offered in Exhibit I-A). The fundamental aspect of "normalization" accounting is that the deferred tax account must "zero out."

The Tax Reform Act of 1986 reduced the highest corporate tax rate, from 46 percent to 34 percent. As a result, a portion of the deferred tax balance that companies had created (at 46 percent) would theoretically be reversed out at 34 percent. This would leave an excess amount of deferred taxes unless remedied. (See Exhibit I-B).

The regulatory authorities' reaction to excess deferred taxes has varied. Except for deferred taxes associated with accelerated depreciation,[1] regulators

---

[1]Section 203(e) of the Tax Reform Act of 1986 [Code section 168(i)(9)] provided a new rule for that portion of a public utilities' excess deferred tax balances <u>associated</u> <u>with</u> <u>accelerated</u> <u>depreciation</u>. According to section 203(e), for a utility to obtain the benefits of accelerated depreciation, excess balances in its deferred tax reserve account (associated with accelerated depreciation) that were created by the 1987 tax rate reduction must be normalized. An excess deferred tax reserve is normalized under the 1986 Act only if in setting utility rates the reserve is not reduced more rapidly than it would be reduced under the "average rate assumption method." The average rate assumption method reduces the excess deferred tax reserve (associated with accelerated depreciation) over the remaining regulatory lives of the assets that gave rise to the reserve for deferred taxes. Under this method, the excess deferred tax reserve is reduced with respect to <u>each item</u> of property over the remaining life of the

(continued...)

have generally taken any excess into account in conjunction with all other cost of service components for each utility on an individual basis before determining the rate treatment to be accorded excess deferred taxes. The Federal Energy Regulatory Commission (FERC) in FERC Order No. 144, 46 FR 26613, [and Order No. 144-A, 47 FR 8329] expanded and clarified rules for tax normalization, and the author(s) of these orders anticipated the occurrence of tax rate changes. The Commission in Order No. 144 states:

> The Commission agrees that tax laws and, particularly, tax rates may change, but we also agree with the reply comments that this possibility is not a basis for failing to provide for deferred taxes. If income taxes are computed on a normalized basis for cost of service purposes, items of expense and revenue entering into the cost of service determination are also used in determining the income tax allowance portion of the cost of service. The tax effects, determined at the current tax rate, of the

---

(...continued)
property beginning in the year in which regulatory depreciation exceeds tax depreciation. This method results in excess deferred taxes being returned to ratepayers in a manner similar to how they would have been paid to the Federal government had the tax rate not been reduced. See Exhibit II for an illustration and example of the average rate assumption method. (Note that Section 203(e) of the Tax Reform Act of 1986, in effect, sets the fastest pattern that excess taxes relating to accelerated depreciation may be returned to ratepayers, but does not restrict regulators from spreading the return over longer periods, or allowing utilities to retain them permanently).

It is important to bear in mind that this legislative "soft landing" (i.e. the average rate assumption method) doesn’t change the inevitable - it just postpones it. The excess deferred taxes will eventually reverse. It is also noteworthy that neither the Federal tax statutes nor utility regulatory statutes require a recomputation of deferred taxes for pre-1987 years. The average rate assumption method, as illustrated in Exhibit II, affects the deferred tax balance in post-1986 years. Consequently, at the Federal tax level and at the state (and Federal) regulatory level, a utility’s pre-1987 revenues are left intact and are not deemed to have been unauthorized, refundable or overcollected. The normalization process is recognized as a process that reverses itself. The excess deferred taxes, created by normalization accounting and the change in corporate tax rate, also must be reversed. The average rate assumption method is the statutory designated method to reverse excess deferred taxes relating to accumulated depreciation. It is not a method to return income (i.e. deferred taxes) that a utility collected erroneously in a prior year; however, it is a method to ensure that normalization accounting remains a timing device and that earlier entries establishing deferred tax reserve amounts are appropriately reversed in later years.

difference between the amounts so used and the amounts claimed in the tax return are placed in a deferred tax account to be used in later periods when the differences reverse. The balance in the deferred tax reserve is therefore a residual of past tax costs over past tax payments and may or may not be sufficient to cover future tax payments over future tax costs, depending on the statutory tax rates in the future. Any excess or deficiency in the deferred tax reserve does not, however, result in a windfall to either shareholders or ratepayers since the balances will systematically be subject to a reconciliation in future rates.

As stated in the reply comments, any disparity between the actual tax effect in the year the timing difference originates and in the year the timing difference reverses is a normal and inherent part of the accounting process. This variation is no more than that involved in assigning the original cost of properties used in providing customer service to the periods of use. Simply because the deferred tax accounting process may not assign the "perfect" amount to each respective period is no reason to reject the practice.

State regulatory bodies appear to have taken a similar approach as that embraced by FERC. Excess deferred taxes have not caused retroactive rate adjustments nor refund orders but rather have been subject to reconciliation in future ratemaking proceedings. In summary, the regulatory authorities did not have to react to the tax rate change associated with the Tax Reform Act of 1986. The regulatory community, at least at the federal level, had envisioned tax rate changes when tax normalization rules were adopted and offered guidance as to how tax rate changes were to be handled by ratemakers. This guidance did not mandate retroactive ratemaking and did not mandate rate refunds. Instead, FERC established a rule whereby utilities were to establish a plan to systematically reconcile such excess (or deficiency) in establishing future rates.

FERC's policy with respect to tax normalization and changes in tax rates was restated in FERC Order No. 475, 52 FR 24987, and Order No 475-A, 41 FERC Para. 61,029. These rulemaking documents adopted a generic approach with respect to the effect the Tax Reform Act of 1986 and the lowering of the corporate tax rates would have on a regulated public utility's rates. These FERC Orders allowed a utility to use an expedited procedure to adjust rates charged to its consumers. In these orders, the question of excess deferred taxes (termed "overaccruals of a utility's unfunded future tax liability") was addressed as follows:

"Similarly, some commenters requested that the Commission establish a method of returning any overaccruals of a utility's unfunded future tax liability to the ratepayers. The Commission is delaying consideration of any of these excess accruals until a utility's next rate application for the same reasons discussed above with regard to deferred tax makeup provisions. (The Commission believes that potentially complex questions involving any such adjustment should be dealt with in individual ... proceedings, where all parties may question the necessary adjustment.) Utilities are required to establish a plan to return any excess accruals in rate applications. Until the next full rate change application a utility would not receive a windfall because any excess funds the utility collects for deferred income taxes are used as a rate base deduction until ultimately returned to the customers. *N*24"

* * * * * * * *

*N*24 See Order No. 144, 46 FR 26613 (May 14, 1981), FERC Stats. & Reg. Regulations Preambles (1977-1981) para. 61,254 (May 6, 1981); Order No. 144-A, 7 FR 8329 (Feb. 26, 1982) and 477 FR 8991 (Mar. 2, 1981), FERC Stats. & Regs. Regulations Preambles (1982-1985) para. 30,340 (Feb. 22, 1982).

The reversal years are not viewed as "refund" years but merely reflect the agreed upon reversal of charges to tariffs in earlier years of taxes that are now being paid on Federal tax returns. The "refund" (return) of <u>excess</u> deferred taxes is also a reversal of taxes charged to tariffs in earlier years. The reversal of excess deferred taxes speaks to the true mechanics of deferred tax accounting and not to rate refund statutes that require a refund of overcollected or unauthorized revenues. Under normal circumstances, the amount representing "excess deferred taxes" would have been reversed as well. The return of "excess deferred taxes" occurs because deferred tax balances are always intended to be zeroed out and the change in corporate tax rates required specialized treatment to ensure that prior year charges would properly be zeroed out. This is borne out in FERC Order No. 144 which states that any excess in the deferred tax reserve will "systematically be subject to a reconciliation in future rates".

As public utilities have 'returned' excess deferred taxes to ratepayers, pursuant to regulatory orders, they have computed their Federal income tax liability using the tax mitigation provision provided under Code section 1341(a).

<u>LAW AND ANALYSIS</u>:

Code section 1341(a) provides that: (1) if an item was included in gross income for a prior taxable year (or years) because it <u>appeared</u> that the taxpayer had an unrestricted right to such item [1341(a)(1)]; and (2) a <u>deduction</u> is allowable for the current taxable year because it was established after the close of such prior year (or years) that the taxpayer did not have an unrestricted right to such item [1341(a)(2)]; and (3) the amount of such deduction exceeds $3,000 [1341(a)(3)]; then, the tax liability is the lesser of

(i) the tax for the taxable year computed with such deduction, or

(ii) the tax for the taxable year computed without such deduction minus the decrease in tax under Chapter 1 of the Code for the prior year (or years) that would result solely from the exclusion of such item from gross income for such prior taxable year (or years).

Code section 1341(b)(2) provides that section 1341(a) does not apply to deductions allowable with respect to income from the sale of inventory or property held for sale to customers. However, this exception does not apply if the deduction arises out of refunds or repayments with respect to rates made by a regulated public utility and such refunds or repayments are required by a governmental entity described in Code section 7701(a)(33), (including a public service commission) or by an order of a court or made in settlement of litigation or under threat or imminence of litigation.

The statutory criteria referred to above are specific, and all must be met. The most relevant are:

A. The item was included in gross income in a prior year;
B. At that time, it appeared that the taxpayer had an unrestricted right to the item;
C. The lack of an unrestricted right was established after the end of such prior year;
D. A deduction is allowable in the current year for the item identified in 'A' above; and
E. The amount of the deduction exceeds $3,000.

Perhaps the two most important criteria are the establishment by the taxpayer of an apparent unrestricted right [(B) above] and that a deduction has occurred in the current year [(D) above].

DEDUCTION IN CURRENT YEAR

Notwithstanding an occasional loose reference to amounts that are "deductible under the provisions of Section 1341," see, Blanton v. Commissioner, 46 T.C. 527, 529 (1966), it is clear that a taxpayer must look outside of Section 1341 - primarily to sections 162 and 165 - to establish that a deduction is "allowable." In other words, Section 1341 is concerned exclusively with the *computation* of tax liability. United States v. Skelly Oil Co., 349 U.S. 678, 681 (1969).

In Iowa Southern Utilities Co. v. United States, 87-1 USTC Para. 9217 (1987); aff'd, 841 F.2d 1108 (Fed. Cir. 1988) the Claims Court addressed a deduction from income versus a reduction in income. Although the facts set forth in Iowa Southern are not directly on point, the legal reasoning is analogous.

In Iowa Southern, a public utility that added a surcharge to its electrical ser vice in order to defray the cost of building a new coal-fired plant was required to include the surcharge in gross income as compensation for services. The amounts collected from the surcharge were to be "refunded" to the customers in the form of reduced rates (negative surcharge) after the plant was completed. The utility was not entitled to deduct as a business expense the amount attributable to its obligation to credit negative surcharges to customer's bills in future years. The negative surcharge represented a reduction in rate or price change and not a liability. Thus, there was no deductible expense.

The Court in Iowa Southern stated:

> "A deduction, for federal income tax purposes, involves a cost or expenditure that is incurred in the process of producing income from a trade or business. *See* I.R.C. Sec. 162(a). We do not have that here. Granted, the language of the stipulation, and also that of the tariff sheets, speaks in terms of a "refund" of the surcharges. But the fact of the matter is that these documents set up no obligation to pay; they establish no liability. Rather, all that they accomplish is a declaration of regulatory policy: that rates shall be raised in certain years and then lowered in subsequent years to offset the increase. It suggests a confusion in thought to argue that the expected future reduction in the charges for electric service qualify as a cost, *i.e.*, a deduction, incurred in the process of producing the income generated through the allowed increase in charges. Perhaps in some broad economic sense there may be room for that sort of argument, but not in federal tax law. The negative surcharges represent a price change; not a liability. Accordingly, there existed no deductible expense to accrue."

In Roanoke Gas Co. v. U.S., 92-2 USTC Para. 50,496 (1992), the taxpayer was denied a deduction for "refunds" of revenue overcollections received in one period which were by rate regulation incorporated as an adjustment (i.e. decrease) to rates in a future period. The company claimed a deduction for overcollections in the year the overcollections were received; however, the court found that "the obligation to make a future rate adjustment does not constitute an expense but rather represents a regulation of income." See also Southwestern Energy v Commissioner, 100 T.C. 500 (1993); but cf. Houston Industries, Inc. and Subsidiaries v. United States 94-2 USTC Para. 50,526 (1994). Clearly, the weight of authority supports the conclusion that the obligation to restore the overrecoveries results in reduced income under Section 61.

Iowa Southern, Roanoke, and Southwestern Energy illustrate ratemaking situations where expected future rate reductions were held not to represent current deductions from taxable income, but merely regulation of income through rates. The tax normalization rules found in FERC Order No. 144 (and restated in FERC Order No. 475) concerning tax rate changes are also recognized future rate reductions and, similar to Iowa Southern, Roanoke and Southwestern Energy, do not represent current deductions from income but merely future reductions in income. As the "return" of excess deferred taxes by regulatory bodies represents a future reduction in income and not a current deduction from income, the provisions of Section 1341 are not available.

APPARENT UNRESTRICTED RIGHT

If an item is to be granted the special computations provided by Section 1341, that item must be shown to have been included in gross income in a prior taxable year because it appeared that the taxpayer had an unrestricted right to such item [1341(a)(1)].

The Service has continually distinguished between an appearance or semblence of a right which is later determined not to have existed as opposed to an absolute right in fact and law which is annulled through a subsequent event.

In Revenue Ruling 58-226, 1958-1 CB 318, the Service analyzed the applicability of Code section 1341 to the refund of prepaid interest (reported as income in the year of receipt) on a ten year note. The prepayment of any portion of the principal amount of the note in a subsequent year did not mean that the taxpayer did not have an unrestricted right to the prepaid interest received and reported in a prior year. The Service ruled that Code section 1341 was not applicable as the taxpayer had a right to the prepaid interest in fact and in law, and the repayment of the interest in a later taxable year could not be predicated upon any lack of that right initially, but because a liability had later accrued. (Emphasis added).

In Revenue Ruling 67-48, 1967-1 CB 50, the Service analyzed whether Code section 1341 could be applied to liquidated damages paid to a former employer for breach of contract. The Service stated that "section 1341of the Code is not applicable where the taxpayer did, in fact, have an unrestricted right to receive the amount and where the obligation to repay arose as the result of subsequent events". (Emphasis added).

In Revenue Ruling 68-153, 1968-1 C.B. 371 (and G.C.M. 33545), the Service analyzed four situations involving railroad rates in order to clarify the differences between the appearance ("semblance") of a right from an absolute right and absolutely no right at all.

In GCM 33545, the Service stated that the "semblance of an unrestricted right requirement is satisfied if there is a legal or factual uncertainty, whether known or unknown in the year of inclusion which cannot be resolved until a subsequent year." (Emphasis added).

Revenue Ruling 68-153, 1968-1 C.B. 371, 373 provides:

> The term "appeared" as used in section 1341(a)(1) of the Code and in section 1.1341-1(a)(2) of the regulations refers to a semblance of an unrestricted right in the year received as distinguished from an unchallengeable right (which is more than an "apparent" right) and from absolutely no right at all (which is less than an "apparent" right). Whether the taxpayer had the semblance of an unrestricted right in the year of inclusion depends upon all the facts available at the end of such year. Under section 1341(a)(2) of the Code it must be established in the subsequent year that in the year of inclusion the taxpayer did not in fact or in law have an unrestricted right to the amount in question. (Emphasis added).

In other words for section 1341 of the Code to apply to the repayment of an item of income, a taxpayer must be found to have not had complete entitlement to the item in the taxable year in which it is included in the taxpayer's gross income. Accordingly, there must be a factual or legal uncertainty concerning the taxpayer's right to the item of income in that year. Thus, section 1341 does not apply if a taxpayer has an absolute right to income in the taxable year it is included in the taxpayer's gross income, but the taxpayer voluntarily pays the income back in a subsequent taxable year. E.g. see Kappel v. United States, 437 F.2d 1222 (3d Cir. 1970), cert. denied, 404 U.S. 830 (1971) (section 1341 does not apply to repayments of pension fund distributions if there is no legal obligation to return the distributions to the pension funds).

Section 1341 of the Code also does not apply if a taxpayer has a right to income based on facts that exist at the close of the taxable year of inclusion, but loses the right to that income in a subsequent taxable year based on a subsequent event. For example, see Rev. Rul. 68-153, Situation 4. Indeed, under section 1341(a)(2) it must be established, after the close of the taxable year of inclusion, that in the taxable year of inclusion the taxpayer did not have an unrestricted right to the item of income.

In the current situation, the utility was required to collect the tax expense (through normalization) <u>using the applicable statutory rate</u>. Under the mechanics of normalization, the 'deferred taxes' relative to each asset would ultimately have been paid over to the government over the life of that asset. A portion of the deferred taxes have become 'excess' only because of a <u>subsequent event</u> (i.e. the change in the Federal statutory rate). It is important to note that the excess deferred taxes at issue were not and are not deemed to be excessive at the year end of the revenue inclusion year(s). Rather, the reserve account became excessive with the effective date of the Tax Reform Act of 1986. <u>In the year of inclusion</u> there is no uncertainty, the utility <u>had an absolute right</u>, in fact and in law, to the income. The change in the Federal statutory rate is a <u>subsequent event</u> and any corresponding regulatory order (e.g. pursuant to rules outlined in FERC Order No. 144) to effectuate a rate "refund" is <u>not a retroactive rate adjustment</u> but rather a required systematic reconciliation in future rates. Consequently, the collection of revenues relating to excess deferred taxes does not represent a situation where monies were received under an apparent unrestricted right. This conclusion also denies the use of the Section 1341 provisions.

This analysis is supported through comparison of the present situation with cases which turned on the appearance of a right vs. an unrestricted right changed by a subsequent event in determining the applicability of Code section 1341.

In <u>H. B. Wallace v. U. S.</u>, 439 F.2d 757 (C.A.8 1971), af'g 309 F.Supp. 748 (S. D. Iowa, 1970), the taxpayer, pursuant to a divorce decree, subsequently transferred to his former spouse dividends received on stock which the taxpayer owned, but which he was required under the decree to assign to his former spouse. The taxpayer's contention that he was entitled to a deduction under Code section 1341 was denied since the court held that he had an unrestricted right to the income upon receipt. Similarly, utilities have an unrestricted right in the year of receipt to deferred taxes collected based upon the applicable federal statutory rate.

In <u>J. G. Pahl v. Commissioner</u>, 67 TC 286 (1976), Code section 1341 did not apply to the repayment of salary to a corporation where the salary was determined to be unreasonable under Code section 162(a) and the repayment was made pursuant to an agreement entered into by the taxpayer and the corporation after the salary was originally paid. Citing <u>G. L. Blanton v. Commissioner</u>, 46 TC 527 (1966), affd. per curiam 379 F.2d 558 (C.A.5 1967), the Tax Court (quoting <u>Blanton</u>) offered that "*under section 1341(a)(2), the requisite lack of an unrestricted right to an income item permitting deduction must arise out of the circumstances, terms, and conditions of the* <u>original</u> payment of such item to the tax*payer and not out of circumstances, terms, and conditions imposed upon such payment by reason of some subsequent ...... (event).*" [See also <u>E. T. Usher v. Commissioner</u>, TC-Memo 1980-180 and <u>Pike v. Commissioner</u>, 44 TC 787 (1965)]. Similarly, in the current situation, the refund is not caused by any circumstance, term or condition existing in the year of inclusion. Rather, the refund of excess deferred taxes arises from the <u>subsequent</u> lowering of the Federal statutory rate and resulting action by a regulatory authority.

In W. L. Coon vs. U.S., 87-1 USTC Para. 9150, a sole shareholder was entitled, under Code section 1341, to a refund of a portion of his individual income tax payment which was computed on a distribution in complete redemption of stock and where, later, it was discovered that a portion of the distribution was subject to the corporation's final tax liability. The court stated that "the inquiry in determining whether a section 1341 deduction can be made is whether the events upon which the claim of right is defeated existed at the time that the claim on the property was made." In that case, the taxpayer's claim to the entire distribution was defeated by the corporation's tax liability, which existed at the time the distribution was made. In contrast, a utility's deferred taxes have become excess only as a result of the change in the Federal statutory rate which occurred subsequent to the year of inclusion.

In all situations (whether or not a regulated utility is involved) where section 1341 has been applied, the deduction arises out of the circumstances, terms and conditions of the original payment of the item to the taxpayer. In the current situation, however, the orders to reduce future rates are not based upon anything now known that, if known in the year of inclusion, would have changed the rates used to collect revenues from ratepayers in that year. Rather, there was an absolute right to the income collected from the ratepayers.

CONCLUSION:

In order to receive section 1341 treatment for an item, a taxpayer must establish that the item at issue represents a current deduction. As analyzed earlier, regulatory orders associated with tax rate changes and tax normalization establish regulatory policy - namely, that rates should be systematically reconciled. It is, as stated in Iowa Southern, a confusion in thought to argue that expected future reductions in rates qualify as a cost or a deduction for Federal income tax purposes. The "return" of excess deferred taxes is in reality a function of deferred tax (normalization) accounting and not a return or refund of prior year revenues. It is recognized that deferred tax accounting results in the zeroing out of deferred tax balances. See Exhibit I-A. The year in which deferred tax reversals occur are not deemed nor looked upon as refund years by utilities, regulators or the accounting profession. Likewise, the reversals of "excess deferred taxes" are not rate refunds but merely a reversal of deferred taxes to guarantee that deferred tax balances are zeroed out. Hence, Section 1341 is not applicable.

Similarly, Section 1341 does not apply if a taxpayer has a right to income based on facts that exist at the close of the taxable year of inclusion, but loses the right to that income in a later taxable year based upon a subsequent event. The deferred taxes at issue were accumulated due to normalization accounting and were based on the then existing Federal statutory tax rate. In the year of inclusion, then, the utility had an absolute right to the income (represented by deferred taxes) in fact, and in law. The ‘excess’ deferred taxes now being ‘refunded’ stem from a change in the Federal statutory tax rate (a subsequent event), and not a change or clarification in the facts existing in the year the deferred taxes were included in income.

<u>Note</u>:

As stated earlier, this narrative explains deferred tax (normalization) accounting by reference to the timing difference associated with accelerated depreciation. Other timing differences exist for which deferred tax accounting is required by regulators. Section 1341 treatment for any excess deferred tax "refunds" should be denied whether such excess stems from accelerated depreciation or other timing differences. Utility taxpayers often label the excess deferred taxes associated with accelerated depreciation as "protected" and all other excess deferred taxes as "unprotected." Utilities should be denied Section 1341 treatment on both "protected" and "unprotected" excess deferred taxes.

Utilities (and regulators) are restricted as to how the "protected" excess deferred taxes can be returned to customers. See the commentary on the average rate assumption method located in this discussion paper and Exhibit II. Utilities (and regulators) are not restricted as to when "unprotected" excess deferred taxes are to be returned. Theoretically, such amounts could be returned in one year, over several years or not returned at all. See FERC Order No. 144, 46 FR 26613.

Exhibit I
(Page 1 0f 2)

A.

A piece of equipment costing $1,000 is placed in service in 1985 when the corporate tax rate is 46 percent. For tax purposes, the equipment is classified as five-year ACRS property. The tax depreciation is therefore based on the five-year ACRS table. For book purposes, the utility used the straight-line method over a ten-year useful life. Assuming that the corporate tax rate re mains constant, the following table illustrates the normalization of the utility's accelerated depreciation under deferred tax accounting principles.

	Depreciation				Deferred Tax Reserve	
Year	Tax	Book	Difference	Tax Rate Factor	Ratemaking Expense	Balance Sheet Amount
1985	150	100	50	46%	23	23
1986	220	100	120	46%	54	77
1987	210	100	110	46%	51	128
1988	210	100	110	46%	51	179
1989	210	100	110	46%	51	230
1990	-0-	100	(100)	46%	(46)	184
1991	-0-	100	(100)	46%	(46)	138
1992	-0-	100	(100)	46%	(46)	92
1993	-0-	100	(100)	46%	(46)	46
1994	-0-	100	(100)	46%	(46)	-0-
	1,000	1,000	-0-		-0-	-0-
	=====	=====	=====		====	=====

Exhibit I
(Page 2 0f 2)

B.

However, with the tax rate change implemented by the Tax Reform Act of 1986, an excess is created in the reserve account as illustrated by the following:

Depreciation					Deferred Tax Reserve	
Year	Tax	Book	Difference	Tax Rate Factor	Ratemaking Expense	Balance Sheet Amount
1985	150	100	50	46%	23	23
1986	220	100	120	46%	54	77
1987	210	100	110	40%	44	121
1988	210	100	110	34%	37	158
1989	210	100	110	34%	37	195
1990	-0-	100	(100)	34%	(34)	161
1991	-0-	100	(100)	34%	(34)	127
1992	-0-	100	(100)	34%	(34)	93
1993	-0-	100	(100)	34%	(34)	59
1994	-0-	100	(100)	34%	(34)	25
	1,000	1,000	-0-		$25	25
	=====	=====	=====		====	=====

Exhibit II

NORMALIZATION (AVERAGE RATE ASSUMPTION METHOD) WITH A CHANGE IN CORPORATE TAX RATES

Commentary:

As stated earlier, the Tax Reform Act of 1986 (TRA 1986) reduced the corporate Federal statutory income tax rate from 46 percent to 34 percent effective July 1, 1987. However, in light of the controversy sparked by the previous corporate tax rate reduction (from 48 percent to 46 percent), Congress recognized the need to enact definitive guidelines for public utilities using the normalization method of accounting. Accordingly, TRA 1986 specifically provided for the normalization of the excess deferred tax reserve resulting from the reduction of the corporate Federal statutory income tax rate. The Act provided that the excess deferred taxes related to depreciation are to be reduced no more rapidly or to a greater extent than the reserve would be reduced under the average rate assumption method.

The average rate assumption method works in the following manner. Under a normalization method of accounting, additions to the utility's deferred tax reserve are made in the early years of an asset's life in order to reflect the deferral of taxes resulting from the difference between the amount of accelerated depreciation used for tax purposes and the amount of straight-line depreciation used for book purposes. The difference between these two amounts is multiplied by the Federal statutory income tax rate in effect at the time of deferral in order to determine the amount of deferred taxes that must be added to the utility's deferred tax reserve. (See Exhibit I-A.)

Downward adjustments to the utility's deferred tax reserve are made in later years of an asset's life, when the amount of straight-line depreciation used for book purposes exceeds the amount of depreciation taken for tax purposes. (Again, see Exhibit I-A.) Because the new tax law will decrease the corporate tax rate from 46 percent to 34 percent, public utilities that have been making additions to their reserves for deferred taxes based on the 46 percent tax rate will have an excess in their reserve for deferred taxes. (See Exhibit I-B.) The reason for this is that Federal income tax deferrals that had been computed based on a tax rate of 46 percent will be "reversed" out when the new tax rate is only 34 percent. The average rate assumption method for calculating the reversal of deferred taxes ensures the normalization of this excess in the utility's reserve for deferred taxes.

Example:

A piece of equipment costing $1,000 is placed in service in 1985 when the corporate tax rate is 46 percent. For tax purposes, the equipment is classified as five-year ACRS property. The tax depreciation is therefore based on the five-year ACRS table. For book purposes, the utility uses the straight-line method over a ten-year useful life. In 1987, the utility is subject to a blended corporate tax rate of 40 percent, and in 1988 and subsequent years the applicable corporate rate is 34 percent. The following table illustrates the normalization of the utility's excess deferred taxes using the average rate assumption method.

<u>Exhibit II</u>
(Page 2 of 2)
<u>Basic Illustration of Average Rate Assumption Method</u>

Depreciation				Cumulative	Tax Rate	Deferred Tax Reserve	
Year	Tax	Book	Difference		Factor	Ratemaking Expense	Balance Sheet Amount
1985	150	100	50	50	46%	23	23
1986	220	100	120	170	46%	54	77
1987	210	100	110	280	40%	44	121
1988	210	100	110	390	34%	37	158
1989	210	100	110	500	34%	(39)	195
1990	-0-	100	(100)	400	39%*	(39)	156
1991	-0-	100	(100)	300	39%*	(39)	117
1992	-0-	100	(100)	200	39%*	(39)	78
1993	-0-	100	(100)	100	39%*	(39)	39
1994	-0-	100	(100)	-0-	39%*	(39)	-0-
	1,000	1,000	-0-			-0-	-0-
	=====	=====	=====			=====	=====

* Deferred tax reserve balance of 195 divided by the associated cumulative difference of 500.

As shown in the table above, additions to the utility's deferred tax reserve in years 1985 through 1989 are computed based on the effective tax rates for those years (i.e., 46 percent in years 1985 and 1986, 40 percent in year 1987, and 34 percent in years 1988 and 1989). The reversals from the utility's deferred tax reserve in years 1990 through 1994 are computed using the weighted average of the effective tax rates for years 1985 through 1989.

The weighted average rate is an historical composite tax rate used to provide deferred Federal income tax. It is the ratio of the cumulative deferred taxes (i.e., the balance in the deferred tax reserve immediately before the turnaround period) over the total remaining timing differences for which the deferred taxes were provided.